BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	CC Docket No. 93-193
1993 Annual Access Tariff Filings	)	

TO THE COMMISSION

REBUTTAL OF SOUTHWESTERN BELL TELEPHONE COMPANY

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SUMMARY*

On this issue, the time has come to treat SWBT and the other price cap LECs fairly, by allowing the marketplace to determine the extent to which price cap LEC prices recover SFAS-106 costs. Just as the marketplace makes this determination for the nonregulated portions of the U.S. economy, the price cap LECs must be allowed the flexibility to determine the extent to which their rates recover SFAS-106 costs.

All LECs operating under rate of return regulation, as well as several price cap LECs, have already obtained rate recovery for SFAS-106. SWBT's competitors (CAPs) are not currently constrained by the Commission's price cap scrutiny and may recover SFAS-106 costs in their rates. SWBT should be allowed to do the same.

Even under the increased and changing burden of proof placed upon the price cap LECs, the price cap LECs have shown that: they do not exert sufficient control over SFAS-106 costs; SFAS-106 costs are not "double counted," such costs are "real;" and their recovery does not violate price cap incentives.

Even if, arguendo, the Commission does not find that exogenous treatment for SFAS-106 costs is fair, or that the price cap LECs have met all relevant measures of their burden of proof, exogenous treatment should still be allowed subject to reasonable safeguards, in order to eliminate any remaining perceived danger to ratepayers.

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*All abbreviations used herein are referenced within the text.

Finally, SWBT shows herein that no party has provided a compelling reason to place LIDB query charges in a category other than Transport.

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Pursuant to the MO&O in the above-referenced docket,[1] Southwestern Bell Telephone Company (SWBT) hereby files its Rebuttal. This Rebuttal shows that SWBT has borne its burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the Transition Benefit Obligation (TBO) amounts, and that SWBT has properly placed Line Information Database (LIDB) query charges in the Transport category.

I. SWBT HAS BORNE ITS BURDEN OF DEMONSTRATING THAT IMPLEMENTING SFAS-106 RESULTS IN AN EXOGENOUS COST CHANGE FOR THE TBO AMOUNTS UNDER THE COMMISSION'S PRICE CAP RULES.

If the question of exogenous treatment were decided solely on the merits, the price cap Local Exchange Carriers (LECs) would be allowed exogenous treatment of the increased expenses that now must be recognized under mandatory SFAS-106 accounting. There is no question that these costs are legitimate regulated expenses which relate to prudently incurred health care expenses deferred under the pay-as-you-go method of accounting. Approximately 90% of the state regulatory decisions regarding SFAS-106 (38 of 42

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[1] 1993 Annual Access Tariff Filings, CC Docket No. 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation (DA-93-762) (released June 23, 1993) (MO&O).

jurisdictions) have allowed an opportunity for rate recovery of SFAS-106.

Nevertheless, the question of exogenous treatment has become blurred by many of the irrelevant issues raised by the oppositions.[2] For example, the debates over hypothetical double counting effects, conjectured by some parties, pale in importance to the basic issues of fairness. All LECs operating under rate of return (ROR) regulation (and several price cap LECs) have already obtained explicit rate recovery for SFAS-106.

The price cap companies should be allowed to keep their price caps at the levels allowed in July of 1993 to provide an opportunity for rate recovery of the incremental retiree health care costs that must now be recognized (SFAS-106). The Commission must now treat SWBT and the other price cap LECs fairly, by allowing the marketplace to determine the extent to which price cap LEC prices recover SFAS-106 costs, just as the marketplace makes this determination for the nonregulated portions of the U.S. economy.[3]

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[2] Oppositions were filed by: MCI Telecommunications Corporation (MCI), American Telephone & Telegraph Company (AT&T), Ad Hoc Telecommunications Users Committee (Ad Hoc) and Allnet Communication Services, Inc. (Allnet).

[3] While AT&T has opposed SWBT's efforts in this proceeding, it has filed its own request for exogenous treatment of SFAS-106 (AT&T Communications Tariff F.C.C. Nos. 1 and 2, Transmittal Nos. 5460, 5461, 5462 and 5464, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, CC Docket No. 93-193, Phase II (DA 93-979) (released August 10, 1993). AT&T's attempt to "hedge" its position supports SWBT's request to allow the marketplace, not the Commission, to determine the extent to which SFAS-106 will be recovered in rates.

A. Consideration of the Evolving Competitive Landscape.

None of the oppositions successfully rebut SWBT's contention that the evolution of competition must be considered in determining the appropriate time horizon for rate recovery opportunities. Once competition is considered, a different answer to the SFAS-106 debate than was reached in CC Docket No. 92-101 is warranted.

Competition reduces the overall customer base to the extent that competitors take away customers of the incumbent provider. This assumption is generally accepted when a monopoly market is opened up to new competitors as has been the case in the interexchange markets and will be the case in exchange access markets.

SFAS-106 requires current customers to pay for the expenses of current employees, by matching the accounting period to the period in which the employee earns future retirement benefits. Those expenses will be less if paid today than if paid years down the road after factoring in inflation. If rate recovery proceeds at a pace based on price cap rates set on a pay-as-you-go basis, the next generation of customers will be required to pay for this generation of employees' retirement benefits. That would be unfair even if the base of customers were to stay fairly stable, but it is truly unfair when competition can be expected to significantly decrease the customer base in the future.

The New York Public Utility Commission (PUC) was concerned about competition when it required the adoption of SFAS-106 by utilities subject to its jurisdiction:

> OPEB[s], like pensions, are a form of deferred compensation. In exchange for the employee's current services, the employer promises both current benefits (e.g. wages) and deferred benefits, (e.g. OPEB). Since today's customers receive the benefits of the employees' services, it is reasonable that they pay for the cost of the employees benefits at the time service is rendered. This philosophy would include benefits paid at a later date, such as during retirement. The alternative is to allow the companies to build a liability beyond the $3.4 billion owed by the customers to date and recover those amounts from future customers. The latter approach could be of particular concern to industries where competitive inroads are likely to reduce the number of customers from which OPEB liabilities might be recovered. There is also a question of fairness to future generations which weighs on the side of current recovery.[4]

Just as the New York PUC has concluded, "fairness" dictates that SFAS-106 be paid for by current customers. Competition increases the need for recovery in current rates, not future rates.

B. Burden of Proof.

SWBT has borne its burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the TBO amounts.

1. Lack of Control.

To meet the control standard established by the Commission for exogenous treatment, SWBT need only show that the incremental effect of the accounting change is beyond its ability to control. SWBT and the other price cap LECs have already made this showing.

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[4] Case 91-M-0890, State of New York Public Service Commission, Notice Soliciting Comments, issued March 19, 1992, Appendix, p. 7. (Footnote omitted).

The opponents continue their attempt to have the Commission apply an inappropriate standard for the control prong of the test for exogenous treatment. The LEC Price Cap Order states that "exogenous costs are in general those costs triggered by administrative, legislative or judicial action beyond the control of the carriers."[5] The action beyond the control of the carriers was triggered by the Financial Accounting Standards Board (FASB) and the Commission.[6]

NYNEX correctly points out in its Direct Case[7] that acceptance of the opponents' arguments -- that control over the cost of administering health care benefits is an appropriate rationale for concluding that SFAS-106 is within the carriers' control -- would negate all items currently eligible for exogenous treatment, making Section 61.45(d) of the Commission's Rules a nullity.[8] The existing Part 61 rules contain explicit provisions for exogenous adjustments in areas where carriers have some ability to control the level of costs to which an administrative, legislative or judicial change may be imposed.[9]

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[5] Policy and Rules Concerning Rates for Dominant Carriers, 5 F.C.C. Rcd. 7664 (1990), para. 166 (LEC Price Cap Order).

[6] In compliance with the Commission's request, SWBT adopted SFAS-106, effective January 1, 1993.

[7] NYNEX Direct Case, Exhibit 1, pp. 14-16.

[8] See, Bellsouth Direct Case, p. 4; Pacific Bell Direct Case, p. 4.

[9] NYNEX Direct Case, Exhibit 1, p. 15.

For example, while carriers would not control the effects of a change in Part 36 Separations Rules,[10] they would have some control over the basic cost items upon which a separations rules change would be imposed.[11] Thus, under the oppositions' logic, separations rules changes would be endogenous, not exogenous. This would clearly be a nonsensical result, invalidating previous exogenous amounts required by the Commission that have reduced rates by over $1 billion in annual revenue.

Some oppositions claim that the LECs have failed to show that the Other Postretirement Employees' Benefits (OPEB) TBO expenses are not within their control and that they are not able to vary the level of benefits provided to their employees.[12] They cite the LEC benefit arrangement documents as proof that the LECs retain legal control of these benefits.[13]

As SWBT has already demonstrated, a narrow focus on whether a carrier happens to retain a specific legal right to modify OPEB plans should not be dispositive of the broader issue of whether rate recovery of the increased costs recognized under SFAS-106 accounting is warranted.[14] The Commission, like the FASB, should look past the legal issue to the practical effects of OPEB obligations.

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[10] Changes in separations rules are universally recognized as exogenous and are listed as such in Section 61.45(d) of the Commission's Rules.

[11] BellSouth, p. 4.

[12] AT&T, p. 6. See also, MCI, p. 5; Allnet, p. 3.

[13] AT&T, p. 9.

[14] SWBT Direct Case, pp. 11-15.

AT&T has acknowledged that a focus on legal rights alone is not dispositive of the control issue.[15] AT&T, however, asserts that practical considerations are "irrelevant to the issue of 'control.'"[16] To the contrary, they go directly to the issue of the control standard that the oppositions wish to impose.[17]

The FASB considered the "control" issue and concluded that there is a significant cost if a company attempts to lower OPEBs.[18] Thus, FASB determined that a significant liability exists, knowing that many companies retain the specific legal right to modify or terminate OPEB plans.

Even a study relied upon by MCI clearly acknowledges the lack of control:

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[15] AT&T does not disagree with the observation that significant considerations, such as labor relations, public relations, principles of ethical behavior, and the ability to attract and retain qualified employees, impose practical limits on the LECs' ability to alter the retiree benefits represented by the OPEB TBO. AT&T, p. 10.

[16] Id.

[17] SWBT does not acknowledge the appropriateness of this standard, but here rebuts the flawed claims that the opponents make regarding their proposed standard.

[18] FASB looked beyond the legal status of the promise to consider whether the liability is effectively binding on the employer because of past practices, social or moral obligations, or customs. SFAS-106, at para. 156. An enterprise is considered to be obligated for these benefits unless it can avoid the future sacrifice at its discretion without significant penalty. The penalty to the employer need not be in the form of a reduction in the value of assets. It could refuse to pay only by risking substantial employee-relations problems. As a practical matter, it is unlikely that an employer could terminate its existing obligation under a postretirement benefit plan without incurring some cost. Therefore, FASB concluded that in the absence of evidence to the contrary, an employer is presumed to have accepted responsibility to provide the promised benefits. Consequently, the accounting is based on the presumption that the plan will continue and that the benefits promised by the employer will be provided. SFAS-106, at para. 157.

> Legal and practical considerations may make the benefits [OPEBs] a fairly fixed obligation. As a legal matter, the ability of employers to cancel or amend benefits is highly uncertain, owing to different precedents established in various circuits of the federal courts in interpreting the language of contracts and the intentions of relevant parties. More importantly, as a practical matter, concerns about ethics, labor relations (particularly in a unionized environment), and public relations impose constraints on the ability of employers to act unilaterally on this issue.[19]

AT&T suggests that if an employer reserves its right in governing plan documents to modify the terms of its medical plan, it will generally be permitted to unilaterally modify the level of benefits paid, even for employees subject to labor contracts.[20] AT&T mischaracterizes the ability of SWBT to unilaterally change OPEBs, stating:

> For collectively bargained employees, retiree medical benefits that are explicitly limited to the duration of the collective bargaining agreement may be reduced or discontinued upon expiration of that agreement.[21]

Nevertheless, SWBT's Benefit Agreement language does not contain any such statement of explicit limitation.[22] Further, as the Communications Workers of America (CWA) has already stated on the record, it has bargained hard during numerous rounds of

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[19] H. Fred Mittelstaedt and Mark Warshawsky, The Impact of Liabilities for Retiree Health Benefits on Share Prices, Federal Reserve Board Paper Number 156, April 1991, p. 3. This study was relied upon by MCI in its Opposition to Direct Cases, CC Docket No. 92-101, filed July 1, 1992.

[20] AT&T, p. 8.

[21] AT&T, p. 8.

[22] See, SWBT's Direct Case, Appendix B.

collective bargaining to ensure retention of health care benefits.[23] It would be a grossly incorrect characterization of CWA's bargaining power and its commitment to retain these benefits to suggest, as does AT&T, that SWBT has unilateral control over OPEBs after the current contract period has ended. The fact that the terms of collective bargaining agreements are subject to renegotiation at regular intervals does not imply that the CWA would somehow lose all of its bargaining power on this or any other issue. AT&T's attempt to dismiss these practical implications, based on the regular renegotiation of contracts, is seriously flawed.

MCI suggests that SWBT has not demonstrated that altering the cost of providing OPEBs is not possible.[24] Again, MCI misconstrues the control issue. SWBT has presented the Commission with a very conservative exogenous amount proposal.[25] MCI grossly distorts SWBT's statements regarding SWBT's managed health care

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[23] See, letter from Victor C. Crawley, Vice President, District 6, CWA, to Chairman James Quello, June 18, 1993, SWBT Direct Case, Appendix F. Identical letters were sent to Commissioner Barrett and Commissioner Duggan on the same date.

[24] MCI, p. 17.

[25] SWBT's exogenous amount: excludes not just a minimal amount, but an over-estimate, of Gross National Product-Price Index (GNP-PI) double counting; excludes an over-estimate of a national wage rate effect which realistically and according to the Commission's rules should not be made; excludes a significantly higher level of pay-as-you-go costs than is embedded in its price cap rates; incorporates a benefit cap that limits future medical inflation rates to zero percent for future retirees. SWBT Direct Case, pp. 15-18.

plan and other related efforts.[26] SWBT never claimed that "cost efficiencies in the health care industry have ceased."[27]

In fact, SWBT continues to be a leader in the implementation of health care cost efficiencies. SWBT has been successful at reducing the rate of increase in per capita medical care costs. Through aggressive actions SWBT has been able to affect the historical growth rate in its costs of providing health care benefits.

The essential point that MCI has not grasped is that the benefit cap used in SWBT's valuation requires such large future efficiencies so as to provide assurance that its exogenous amount is very conservative.[28] SWBT's exogenous amount assumes zero percent medical care inflation rates for all future retirees after 1995. Contrary to MCI's assertion, SWBT assumes massive future cost efficiencies in the health care industry.

Even assuming, arguendo, that the opponents proposed control standard could be found to be the appropriate one, their discussion of the control issue has become one of semantics. The bottom line is that SWBT could not restrict nor eliminate retiree benefits without swift and serious consequences to its employee relations and customer service. These consequences include the potential for strikes, similar to the 100-day strike the CWA organized against NYNEX when that LEC sought to reduce retiree health care benefits in 1989, or litigation similar to that in

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[26] MCI, p. 18.

[27] Id.

[28] SWBT Direct Case, pp. 17-18.

which McDonnell Douglas Corporation is presently embroiled. Whether the LEC would win or lose such fights -- there is case law on both sides[29] -- is not so much the point as the fact that the mere potential for such an expensive, protracted struggle, and the ensuing damage it would have on employee relations and customer service, acts as a strong deterrent to any consideration of benefit reductions.

Beyond the employee relations side of the OPEB legal liability issue are the less emotional tax-related issues. SWBT has elected to make a Section 420 transfer of funds to be used for the payment of OPEB expenses. Having done so, SWBT is required by the tax laws to maintain the same expense levels during a "cost maintenance period" of five years. A new five-year period starts with each Section 420 transfer and effectively restricts SWBT's ability to reduce its benefit expense levels for the next five years and subsequent five-year periods as long as the Section 420 tool is used.[30]

SWBT has also established a Voluntary Employee Beneficiary Association (VEBA) to fund its OPEB liabilities. Many of the ERISA regulations which restrict pension funds also apply to "employee welfare benefit plans," which are defined to include plans, funds, or programs established "for the purpose of ...

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[29] See e.g., UAW v. Yard-Man, Inc., 716 F.2d 1476 (6th Cir. 1983); Bower v. The Bunker Hill Co., 725 F.2d 1221 (9th Cir. 1984).

[30] See, 26 U.S.C.A. §420(c) (West supp. 1993) (Internal Revenue Code).

medical, surgical or hospital care or benefits in the event of sickness, accident, disability [or] death".[31]

Existing restrictions leave little doubt that the OPEB expenses for which SWBT seeks exogenous treatment will continue to be present over time. The preceding facts validate the assumption that OPEBs will continue to be provided after the instant investigation is concluded.

2. Consistency With Price Cap Incentives.

By recommending that the Commission deny exogenous treatment for SFAS-106, the oppositions are essentially attempting to disallow productivity gains that have been, and are expected to be, experienced under price cap regulation.

AT&T suggests that exogenous treatment is not warranted because some price cap LECs are earning within the price cap sharing zones even though these LECs have reflected the higher levels of SFAS-106 costs in their interstate regulated expenses and earnings for 1992.[32] Allnet implies that no recovery is warranted unless the LEC qualifies for a low-end adjustment.[33]

Even MCI, however, recognizes that the price cap system was designed as an alternative form of regulation that produces incentives for carriers to become more efficient and to have the possible rewards of larger earnings.[34] Denial of exogenous treatment in this case threatens to rob LECs of these rewards. An

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[31] 29 U.S.C.A. §1002 (1).

[32] AT&T, pp. 18-19.

[33] Allnet, p. 3; See also, AT&T, p. 19.

[34] MCI, pp. 15-16.

improvement in earnings was a fundamental goal of the price cap form of regulation.

Importantly, SWBT and most other price cap LECs did not begin reflecting SFAS-106 for interstate regulated accounting until January 1, 1993. As a result, AT&T's claim that the results for 1992 earnings have been achieved in spite of the inclusion of SFAS-106 expenses in 1992 is wrong. While AT&T may believe that all of the price cap LECS have adopted SFAS-106 accounting for interstate regulated accounting in their 1992 results, SWBT and many other price cap LECs did not.

As AT&T has correctly stated, the price cap system of regulation was designed to provide carriers with profit-making incentives that exert downward pressure on internally controllable expenses.[35] If the Commission were to deny exogenous cost treatment of costs beyond the control of carriers, then the incentives of the price cap system would be severely curtailed. The effect would be to recapture the productivity gains that the price cap LECs have already achieved and to reduce the profit-making incentives associated with future productivity gains.

SWBT productivity improvements over the past three years have been very hard to obtain. SWBT has relied heavily on its ability to manage controllable expenses. Nonetheless, SWBT's interstate price cap earnings have remained in the "no-sharing" zone.

With an increasingly competitive environment in all of the local exchange markets in the future, prospective productivity

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[35] AT&T, p. 4.

arising from demand growth will be exceptionally difficult to obtain. Since expense cutting is not an effective means of growing a business over the longer-term, the expectations for future growth in productivity will increasingly depend on growth in demand. Thus, denial of exogenous treatment of SFAS-106 will reduce the profit potential associated with future demand growth, severely reducing the incentives provided in the price cap system.

Denial of exogenous treatment would specifically handicap several of the price cap LECs, including SWBT. Disadvantaging the price cap LECs' ability to achieve and maintain at least a portion of their increased efficiencies is inconsistent with the incentives envisioned by all parties as the price cap plan for LECs was being developed.

3. "Real Costs".

MCI contends that SFAS-106 does not result in a real cost change.[36] MCI's contention, however, completely misses the most fundamental point. The LECs have not been historically regulated based on their economic costs; they were regulated based on their accounting costs. ROR regulation used "pay-as-you-go" accounting for OPEBs to establish rates. Rates established under ROR regulation were the initial rates used to implement price cap regulation. Because accounting costs have indeed changed, rates established based on accounting rules that understated costs must also change.

AT&T claims that the accelerated recognition of OPEB costs for financial statement purposes required by SFAS-106 has no

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[36] MCI, p. 6.

real economic impact on any firm[37] and that SFAS-106 does not impose any new economic burden on the LECs.[38] This claim is untrue for firms that have historically been regulated based on accounting costs and for whom accounting rules change.

The price cap LECs have been subjected to regulation that bases prices on accounting costs. If accounting costs as established by the regulatory process are determined to be significantly understated, then it is the responsibility of the regulator and the right of the regulated firm to remedy the historical understatement in prices.

The appropriate remedy under rate of return regulation is to amortize prior period costs that should now be reflected and to establish rates prospectively to recover these prior period costs. One means of accomplishing this remedy under price cap regulation is -- again -- to amortize prior period costs that should now be reflected and to allow exogenous treatment of that amortization.

Neither AT&T nor MCI contend that, if SFAS-106 accounting had been adopted only several months earlier than December of 1990, the current price cap LECs could have been denied rate recovery for the change in accounting rules that more accurately recognize the economic costs of OPEBs.

MCI states that "SWBT, nor any other LEC, has demonstrated that the costs associated with the institution of accrual accounting are real to the firm."[39] The Commission's own

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[37] AT&T, pp. 13-14.

[38] AT&T, p. 15.

[39] MCI, p. 17 (sic).

adoption of SFAS-106 accounting for regulated purposes and the FASB's adoption of the change in Generally Accepted Accounting Principles (GAAP) change in the first place are sufficient evidence to conclude that SFAS-106 costs are real.

Evidence disproves the contention by MCI and AT&T that SFAS-106 adoption does not cause any real effects on firms. A September 1, 1993 Wall Street Journal article[40] reports the results of a Towers Perrin study of the effect of the SFAS-106 accounting rule on the biggest U.S. companies. A representative of Towers Perrin is quoted in the article, saying that:

> clearly, the rule has had a major impact on the financial results of most of the largest U.S. companies -- and a severe impact on some -- even though many companies reduced retiree medical benefits in anticipation of the rule.

The representative also stated that "as companies begin to realize the magnitude of these charges, many will reduce their medical-benefit obligations even more." If, as AT&T and MCI contend, these companies were not affected by the SFAS-106 adoption, then companies would have no reason to implement and plan to implement reductions in benefits to retirees.

4. Double Counting in General.

None of the oppositions present any credible evidence that any remaining double counting exists within any of the aspects of the price cap index calculations.

TBO amounts represent costs associated with prior period costs which will have an extremely small likelihood of ever being

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[40] "Retiree Benefits To Take Bigger Bite on Profits," by Lee Berton, The Wall Street Journal, September 1, 1993, Midwest edition, p. A3.

reflected in any movements in GNP-PI. Yet the price cap LECs continue to remain willing to reduce their exogenous amount amounts by an over-estimate of the GNP-PI effect associated with presumed exogenous treatment of the total incremental costs of SFAS-106 (rather than just the TBO portion).[41]

5. Intertemporal Double Counting.

The oppositions generally contend that intertemporal double counting exists. For example, AT&T states that "there is no difference whatsoever between pay-as-you-go expense and the OPEB TBO expense over time."[42]

AT&T presents a numerical example.[43] However, its primary point is that it takes over 35 years for the value of pay-as-you-go expense to increase to a level where it exceeds SFAS-106 expenses in total.[44] AT&T's table implies that SWBT and the other

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[41] Despite a significantly enhanced record, the oppositions continue to claim that the Godwins study approach is flawed. AT&T, fn. 30; MCI, p. 6; Ad Hoc, p. 4; Allnet, pp. 4-5, fn. 8. The record on the Godwins study conclusively establishes the conservative nature of the Godwins results and provides sufficient assurance that all double counting associated with the effect on GNP-PI of SFAS-106 is removed. The "Godwins adjustment" utilized by SWBT and most price cap LECs includes a reduction in the exogenous amount for a hypothetical national wage rate effect that has a very low likelihood of occurrence, but which provides a significant buffer with respect to any remaining doubt on other double counting issues.

[42] AT&T, pp. 15-16. SWBT disagrees with Rochester's Direct Case at p. 3 that "cash and accrual accounting will, over time, provide revenues sufficient" to recover OPEB expenses. (emphasis added). Unless regulation provides some link between accounting costs and revenues, sufficient recovery would not occur. In the current case, the appropriate link is exogenous treatment.

[43] AT&T, Appendix B-2.

[44] SWBT explained in its Direct Case that the appropriate planning horizon for considering regulatory decisions on rate recovery for SFAS-106 should be less than ten years. Any greater period, for example, more than 20 years, is beyond reason. SWBT

price cap LECs would have to wait at least 35 years for the operation of the price cap formula to make them whole with respect to the permanent acceleration of costs required by SFAS-106. Such a long period for rate recovery is beyond credibility, and ignores both the time value of money and the evolving competitive landscape. AT&T asserts that pay-as-you-go claims dwindle over time as the pool of existing retirees decreases and retirees become Medicare-eligible upon reaching age 65. AT&T's example, however, does not present the full picture with respect to SFAS-106 and OPEBs.

Splitting out the TBO for rate recovery (rather than the whole SFAS-106 expense) presents potentially difficult analytical challenges because the SFAS-106 framework was designed to be examined in its entirety, not in component parts. By ignoring the dynamics that are accurately reflected in the ongoing SFAS-106 Service Cost, AT&T's example automatically condemns the claims data to an untimely and unrealistic decline because the analysis ignores costs. These ignored costs are the increased claims costs and the resulting increase in SFAS-106 OPEB liability that occur each year. As existing employees earn additional OPEBs and as new employees are hired and begin earning OPEBs, additional SFAS-106 liabilities are created. As employees regularly join the retirement population, they replace retirees who leave the retiree population due to death, thereby maintaining a larger group of retirees than represented in AT&T's analysis.

Direct Case, pp. 40-42.

The pattern of negative exogenous adjustments implied by the AT&T analysis is caused primarily by the inappropriate use of a perpetual closed-end group valuation. In reality, OPEB liabilities are recalculated each year to incorporate the hirings, resignations, and deaths experienced by the firm.[45] While each annual valuation looks years into the future using a closed group for determination of the liability for that year, the "group" must be "opened" again each following year to reflect changes in the composition of the employees and retirees. This "reopening" invalidates the AT&T numerical example, in which OPEB claims fall significantly, by 2% to 7% per year, in the second half of AT&T's example.[46] AT&T's example would require that negative exogenous adjustments occur that would eliminate any price cap recovery of OPEB claims amounts as the fixed group of retirees in AT&T's example eventually dies off completely.[47] This excessively

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[45] The need to recalculate OPEB liabilities each year causes analytical difficulties when analyzing a proposal for exogenous treatment of the TBO alone because the FASB and SFAS-106 did not anticipate the need for the TBO to be recalculated each year to reflect the changes that do occur. SFAS-106 does, however, require the recalculation of the Accumulated Postretirement Benefit obligation (APBO) each year, which, as a result, recomputes the liability represented by the TBO. Proposals for exogenous treatment of a portion of the total SFAS-106 calculation (e.g., the TBO) necessitate considerations that were not addressed by the FASB and that are also ignored by AT&T.

[46] AT&T's example that has retiree medical claims costs falling by 2% to 7% per year is just not credible given the situations that gave rise to the need for SFAS-106 accounting in the first place: medical care inflation (absent the further increases caused by growth in utilization) is expected to continue to outpace general inflation; utilization of medical care is increasing, not declining.

[47] AT&T's example presumes that OPEB claims fall to zero (past year 35 in their example), when, in fact, they do not so long as the company remains in business. Thus, AT&T's example presumes that the LECs "close up shop."

punitive result is not even contemplated by the Commission. In reality, OPEB costs do not disappear as in AT&T's example.

6. Double Counting in ROR Represcription.

MCI and Ad Hoc allege that the LECs have not demonstrated that the Commission's ROR represcription does not double count recovery of SFAS-106 amounts if exogenous treatment of the TBO is allowed.[48] These allegations, however, are without merit. They provide no credible rationale for any finding that a double counting exists. Neither MCI nor Ad Hoc have demonstrated the existence, let alone a quantification, of their ephemeral contention.

SWBT has demonstrated that there is no sound logic in the basic contention made by MCI that rate recovery of SFAS-106-determined OPEB costs would affect the Commission's ROR represcription.[49] Neither MCI nor Ad Hoc were able to address SWBT's significant evidence that exposes the flaws in their claims.

No party has disproved the incontrovertible fact that any event that affects earnings expectations affects both earnings expectations and stock prices. For MCI's approach to be valid, a reduction in earnings expectations must exist that is not reflected in earnings expectations but is reflected in stock prices.[50] The necessary showing that demonstrates a reduction in expected earnings is not reflected in expected earnings cannot be made!

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[48] MCI, pp. 19-20; Ad Hoc, pp. 8-9.

[49] SWBT Direct Case, pp. 27-37.

[50] MCI, fn. 22.

MCI claims that "long term earnings growth would be relatively unaffected, thereby causing share prices to decline under the DCF methodology."[51] Such a result could never be proved to exist, despite MCI's groundless contention otherwise. As SWBT demonstrated in its Direct Case,[52] the Commission's ROR Represcription rules used to calculate cost of equity include both stock prices and earnings expectations.[53]

Using the cost of equity methodology relied upon by the Commission, the prior ROR represcription, an event that reduced expectations regarding rate recovery of costs would reduce stock price and earnings expectation, but leave cost of equity unchanged.[54] A lower value of earnings expectation lowers the measured cost of equity, while the lower stock price counteracts the effect of the lower earnings expectation, leaving the measure of cost of equity unaffected.

MCI relies on a study by Mittelstaedt and Warshawsky.[55] MCI claims that this study implies that stock prices were reduced as a result of SFAS-106. Assuming, arguendo, that there is any merit at all in the findings of the Mittelstaedt/Warshawsky study, MCI has provided no proof or theory that implies that double counting could exist in the Commission's ROR represcription. MCI's witness in the 1992 SFAS-106 investigation, Dr. Drazen, whose

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[51] Id.

[52] SWBT Direct Case, pp. 27-29.

[53] 47 C.F.R., Section 65.303. A copy of those rules is attached here as Appendix A.

[54] SWBT Direct Case, pp. 28-31.

[55] MCI, p. 14.